Fourth Quarter 2025 Investment Outlook

R-E-S-P-E-C-T

"R-E-S-P-E-C-T, found out what it means to me."

– Aretha Franklin

"The essence of investment management is the management of risks, not the management of returns."

– Benjamin Graham – The Intelligent Investor

"The riskiest moment is when you're right."

– Peter Bernstein – Against The Gods: The Remarkable Story of Risk

Aretha Franklin was known as the Queen of Soul. She earned this honor through her powerful voice and groundbreaking influence on music and culture. Her 1967 rendition of "Respect" (original version by Otis Redding in 1965) became an anthem for civil rights and women's empowerment, cementing her legacy in the music industry. Aretha was such a music icon that she had an acting and singing cameo in the highly popular Blues Brothers movie in 1980 along with other soul music icons Ray Charles and James Brown. Benjamin Graham laid the intellectual groundwork for security analysis and disciplined portfolio construction. His seminal works, *Security Analysis* (1934) and *The Intelligent Investor* (1949), introduced the concept of investing with a *margin of safety*, a nod to risk management. Graham's teachings influenced generations of investors, most notably Warren Buffett, and helped institutionalize rigorous analytical frameworks that underpin mutual funds, hedge funds, and the Chartered Financial Analyst (CFA) designation. Peter Bernstein's 1996 book traced the evolution of risk management throughout history. Over his illustrious career, Bernstein championed probabilistic thinking and asset allocation, encouraging investors to embrace uncertainty as a core element of strategy. Graham and Bernstein helped transform investing from speculative guesswork into a disciplined profession rooted in fundamental analysis, risk management, and prudence.

Just as risk and return are tightly linked in investing, respect and risk also have a deep connection. Respect is what keeps risk from turning reckless and respecting the risks associated with financial markets means acknowledging its complexity, volatility, and unpredictability. Risk is about understanding that no investment is guaranteed, and that every investment decision carries a potential loss. Investors who respect risk don't ignore or avoid it but rather they analyze it, prepare for it, and build strategies to manage it. These strategies may include diversifying portfolios across different assets or aligning investments with long-term goals and risk tolerance. Respect for risk also applies to the people, processes, and framework behind the investments: macroeconomic indicators, regulatory (tariffs this year), and even the behavioral psychology of other market participants. Respecting risk doesn't mean being afraid of it, but it is very important to be aware of it, and act with discipline and humility, a mindset that separates thoughtful investors from gamblers.

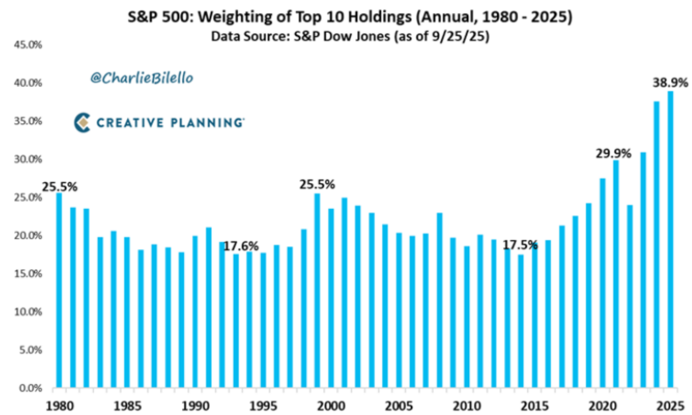
It is a great time to discuss respect for risk because too many market participants usually focus only on returns. Periodically, financial markets go through an extended period of strong returns and investors become overly complacent and don't pay enough attention to the rising risks typically building up under the surface after a long period of positive returns. Since the stock market low in early April after President Trump paused his Liberation Day tariff policy announcement, U.S. stock market returns have been positive for five straights months and had a cumulative gain of 21% from 5/1/25 to 9/30/25. After an extended period of only positive returns combined with a large cumulative return as well, it is human nature to be overly focused on chasing the market for even greater returns. As a result, there is a tendency for more speculative price action to form later in the up-market cycle.

U.S. Households have never been so financially tied to the U.S. stock market in history. As shown in the next chart, equities are now about 83% of U.S. Household financial assets, of which about 73% is invested in U.S. equities. The current level of U.S. household exposure to equities now exceeds the Dotcom bubble peak.

Source: Bridgewater Associates

We are now living in a U.S. centric, artificial intelligence (AI) dominated investment world. There are a select number of stocks globally that are garnering most of the market gains and capital and that list is dominated by U.S. mega cap tech companies. The clever moniker given to them by strategist Michael Hartnett of Bank of America Merrill Lynch was the Magnificent 7 but with the explosive growth of Broadcom (a major AI chip provider) over the past two years they are now called the Elite 8.

What most investors don't know or haven't considered is that the broadly diversified, low-cost U.S. stock index products, which for the past half century have become the mainstay of most U.S. investor portfolios, now reflect increased concentration in the Elite 8. Therefore, the risk profile of the U.S. stock market and the investment products designed to capture its return is substantially different compared to 10 years ago. The next chart dramatically highlights the increased concentration of the S&P 500 Index since 1980. The Top 10 stocks in the S&P 500 Index now represent nearly 39% of the weight of that index compared to 17.5% 10 years ago. Even at the Dotcom bubble peak of 1999, when U.S. stocks were the most overvalued in history, the Top 10 stocks peaked at 25.5% of the S&P 500 Index weight. Also, the surge in the weight of the Top 10 over just the past three years has been incredible.



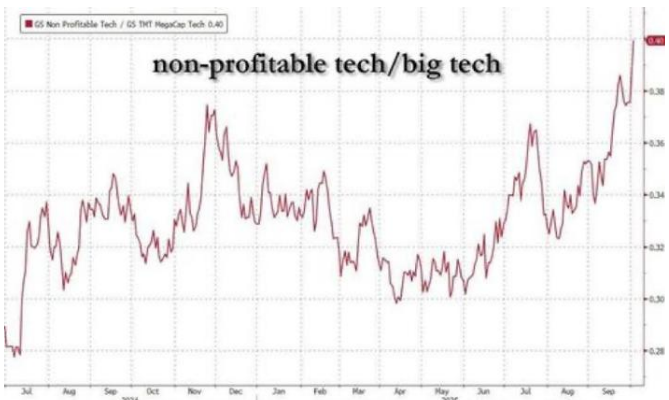
S&P 500 weighting of top 10 holdings (Creative Planning, Charlie Bilello)

Not only is the weight of the Top 10 stocks the highest in history, but the market exposure to the tech sector has also exploded higher and is dominating other broadly defined super sectors like cyclical and defensive stocks. As shown the next chart, the market cap of tech and tech related stocks is approaching 60% of the U.S. stock market. Again, note the incredible surge in the weight of this super sector in just the past two years as AI became mainstream. Back in 2015, the U.S. stock market had a much more balanced weighting and risk profile to these three super sectors.

Life has been grand for the Elite 8 and the investors who were fortunate enough to have ample exposure to them in their portfolios. Most of the Elite 8 who are riding the latest AI mania wave (before that it was cloud computing) are profitable, have high quality balance sheets, and generate sizable positive cashflows. What's not to like about that? Absolutely nothing, they are unequivocally great companies. However, it is important to keep in mind that earlier episodes of rapid technological innovation, such as the 19th-century proliferation of railroads and the 20th-century advent of the internet, entailed vast overinvestment and eventually led to large stock market declines even as they were transformational events for the economy. Therefore, it's pertinent to discuss the risk side of the ledger, which every investor should R-E-S-P-E-C-T and take into consideration when investing the next incremental dollar of their net worth.

If an investor buys an S&P 500 index fund, they are investing 39% of every dollar in only 10 stocks. Nvidia, the largest stock, represents approximately 8% of the S&P 500 Index. Of course, everything has gone quite well for those 10 mega cap stocks over the past decade, as reflected in their current all-time high representation in the S&P 500 index. Nvidia, the clear and dominant global leader in AI, is the largest company in the world with a market cap of $4.5 trillion (that's a t, not a b), which is greater than the total market cap of all the stocks trading in countries such as Germany, France, UK, and Canada.

Whenever a mania hits (it happens in pop culture too like Beatle Mania or the Swifties of today), there are many other stocks that also generate outsized returns as investors speculate more and price momentum kicks in. However, many of these stocks are unprofitable and, in some cases, don't generate any revenues. The next chart shows that since May 2025, the speculative price action in unprofitable tech companies has led to material outperformance even when compared against the big tech market leaders, who have outperformed everything else in their own regard.



Not to pick on one company, but a poster child of the AI related concept stocks is a company called Oklo, Inc. Oklo was founded in 2013 and went public in 2024 (via a SPAC) and intends to build Small Modular Reactors or SMRs. The explosive growth of AI requires massive amount of power generation to supply power to the data centers that run the AI models, which consume a large amount of power. Since the current power generation and transmission infrastructure of the U.S. cannot meet all the forecasted AI demand, the idea of building small nuclear reactors to power data centers has taken investor interest by storm. Building nuclear reactors, even small ones, takes a long time. Even though Oklo isn't expected to generate any revenues for 5 years, that hasn't stopped "investors" from contemplating the future and bidding up the stock price from $10 to $132 (known as a 10+ bagger) over the past year as shown in the next chart. Even with no revenues from SMRs expected for five years, the market cap of Oklo today is nearly $22 billion.

After such an enormous gain in just one year, it is not surprising that insiders are dumping Oklo stock at these recent highs. The CEO and his wife, who co-founded Oklo, both sold $33 million worth of Oklo shares and a director sold another $6 million worth of stock. Of course, this is America and capitalism rules, but it also may be a sign that anyone buying Oklo shares from these insiders may get a hard lesson in respect for risk in the future. Besides Oklo, there are many other concept stocks in the AI realm with huge recent gains all based on hopes for a very profitable future. Caveat emptor.

There are important risk lessons to R-E-S-P-E-C-T from prior manias. The following is from a recent John Authers column on Bloomberg and provides some great lessons on the Dotcom bubble and its aftermath.

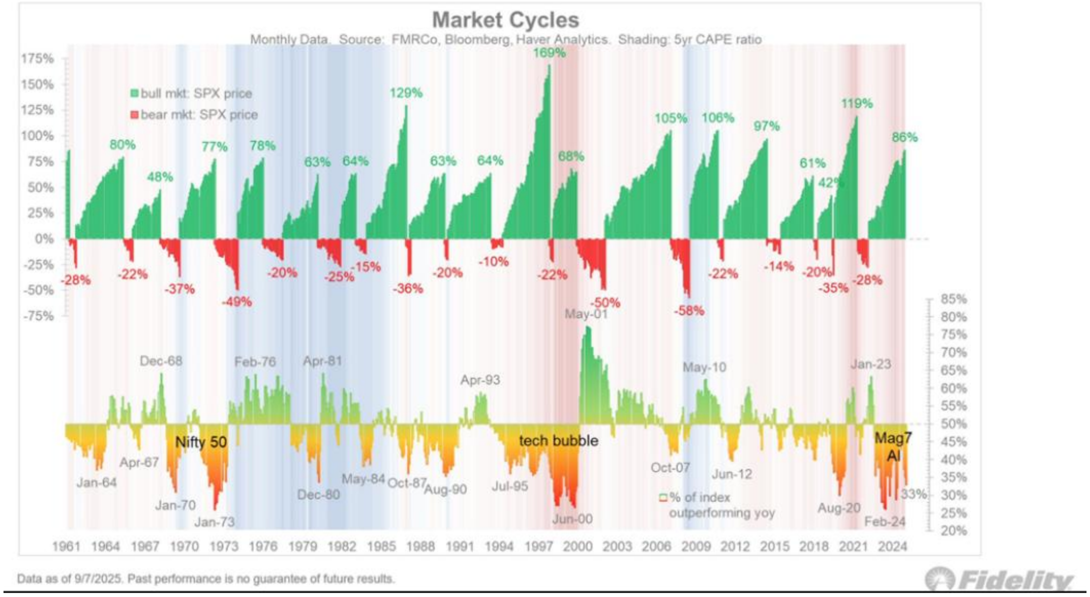
The bursting of the Dotcom bubble happened before Google had gone public. Facebook and Twitter did not yet exist. Netscape Navigator and Microsoft's Internet Explorer were still fighting to be the dominant browser. The money lost by the irrationally exuberant back then did not stop the internet from transforming society and the economy. And several of the leading companies from that era remain in the lead today. However, Ian Harnett of Absolute Strategy Research makes this important point:

The lead players today are still some of the best supported companies from that era — Microsoft/Apple/Oracle/Amazon. However, that didn't stop each of those mega stocks from falling -65%, -80%, -83% and -94% respectively vs their Tech bubble peaks to their troughs. Another salutary lesson is that they took 16, 5, 14, and 7 years respectively to regain those 2000 peak prices!

If you are shareholder, a burst bubble could be really bad news. However, the fact that this AI bubble, like the Dotcom bubble, has been funded primarily by equity is good news for everyone else, as the economic impact should be reduced. Harnett suggests that the correction when it comes will be more like the fallout from the Dotcom bubble than from the financial crisis of 2008, which was driven by defaults on debt and was far more serious for the economy. It should also mean that central banks need to do less in response.

AI probably will have profound consequences on the way we all work. But Schumpeterian creative destruction being what it is, there will be some pain ahead before we all enjoy the businesses that are being built.

In today's market, many investors are chasing AI stocks higher, but as the next chart shows, returns narrow and risk increases after that stock market experiences large gains. Let's review the Dotcom bubble era as one example. As shown in the top half of the chart, from 1994 to March 2000, the stock market cumulative return peaked at 169%. As shown in the bottom half of the chart, the percentage of stocks outperforming the market hit a low of around 25% (orange/red area) at the peak of returns. As gains increased, fewer stocks outperformed, and market returns became more concentrated. Fast forward to September 2025 on the right side of the chart. During this latest U.S. stock market rally (aka The Magnificent 7 Era) the stock market gain is currently 86% but only 33% of the stock are outperforming the broad market index. Note that for three major stock market peaks since 1961, the Nifty 50 Era of the early 1970s, the Dotcom Bubble of late 1990s, and the current Magnificent 7 Era of today, the higher the market gains, the lower percentage of stocks that outperformed. As often happens during manias, investors tend to pile into stocks that experienced the greatest returns during each of those periods. It is also true that the stock market eventually becomes top heavy and once the uptrend broke, the other side of the mountain was not too pretty for the former market leaders. In fact, during each ensuing downturn, more stocks outperformed the broad stock market because more of them fell less than the largest sized stocks which dominated the market returns on the way up to the peak. It remains to be seen if a similar outcome occurs once the current AI mania peaks and recedes.

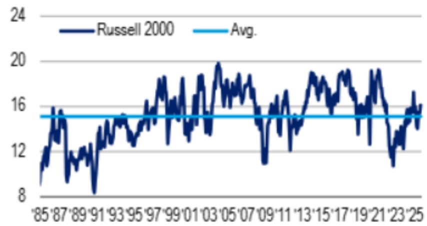


No one can accurately predict when a major stock market correction will occur, but this chart shows that the U.S. stock market risk profile today is more concentrated because outsized sources of return have accrued to fewer stocks. As such, the risk setup of the U.S. stock market and specifically U.S. large mega cap tech stocks are elevated. Therefore, it is a great time to show some R-E-S-P-E-C-T to risk, even if you believe AI will be a transformative technology.

Just because a specific segment of a stock market has an elevated risk profile, it doesn't mean there is an urgent need to slap on your Kevlar helmet, load up on rice, beans, and bottled water, and head for the bunker. While it may be true that investors are currently enamored with AI and the U.S. mega cap tech stocks associated with it, it can also be true that other segments of stocks are less overplayed and don't carry the same degree of risk and offer better risk/reward setups. Two good examples are small cap stocks and non-U.S. stocks.

As global investors gravitated towards mega cap U.S. tech stocks and AI related stocks in recent years, other segments of global stocks have suffered from a high degree of investor apathy because they don't offer enough swag to satisfy investor return appetites. The following chart on the left shows that U.S. small caps are trading at around a 16X forward (next one year) price/earnings (PE) multiple, about in line with their 40-year average forward PE profile. However, as shown in the right-side chart, relative to U.S. large caps, U.S. small caps are trading at a 30% PE discount over that same 40-year period. Small caps have been stuck in relative PE purgatory for three years, about the length of time the Magnificent 7 has dominated the global stock market scene. Small caps are at the same discount level as they were at the peak of the Dotcom bubble when they went on to generate significant outperformance versus large caps over the next eight years (2000-2007) before the Global Financial Crisis hit in 2008. From the March 2009 stock market low, small caps once again materially outperformed large caps through 2012. However, since 2012, U.S. large caps have seen their valuation profile increase substantially compared to small caps. 13 years is a very extended period of time for one segment of U.S. stocks to dominate return outcomes.

Exhibit 1: Small cap forward P/E of 16x is slightly above long-term avg. of 15x
Russell 2000 Forward P/E, 1985-8/31/2025



Source: BofA US Equity & Quant Strategy, FactSet

BofA GLOBAL RESEARCH

Exhibit 2: Small caps remain historically cheap vs large caps: relative forward P/E of 0.73x is below the historic avg. of 0.99x and has been trending around ~0.7x since 2022
Relative Forward P/E: Russell 2000 vs Russell 1000, 1985-8/31/2025

Source: BofA US Equity & Quant Strategy, FactSet

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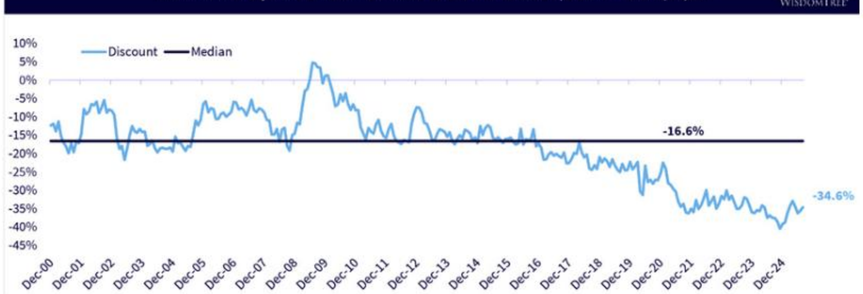
Similarly, the next chart shows the relative forward PE relationship between U.S. stocks (S&P 500 Index) and non-U.S. stocks (MSCI ACWI Ex US) since 2000 or over a 25-year period. Non-U.S. stocks trade at nearly a 35% discount to U.S. large cap stocks. The average forward PE discount of non-U.S. stocks over the past 25 years was -16.6% but today trade at over twice the normal forward PE discount to U.S. large cap stocks. Note that this relative valuation relationship changed quite dramatically starting in 2021, when the Magnificent 7 started to massively outperform every other stock segment globally.

Forward P/E Ratio Valuations – as of 8/29/25

U.S. Current	Ex-US Current	U.S. Historical Median	Ex-US Historical Median
23.4x	15.3x	17.2x	14.1x

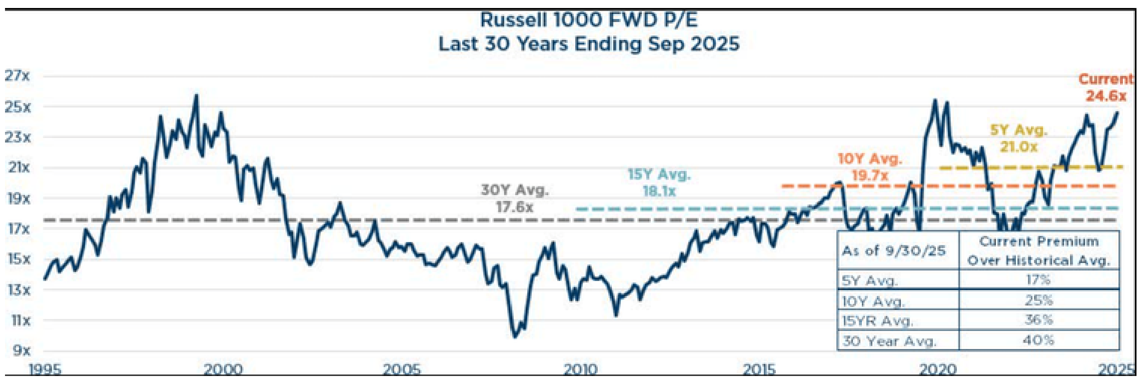
International Equities Valuation Discount to U.S. on Forward P/E Ratio – as of 8/29/25



Sources: WisdomTree, MSCI and S&P. Data begins 12/29/00 to coincide with the inception of the MSCI ACWI ex USA Index. U.S. equities are measured by the S&P 500 Index. Ex-U.S. is measured by the MSCI ACWI ex USA Index. **You cannot invest directly in an index. Past performance is not indicative of future returns.**

Most of the valuation imbalances that exist between various segments of global stocks today are due to the Magnificent 7 substantially outperforming everything else and as such have valuation profiles that are much higher than other segments of global stocks. The next chart focuses on the Russell 1000 Index, which captures the 1,000 largest stocks trading in the U.S. Importantly, the profile of the U.S. stock market has changed dramatically over time such that referencing a long-term average forward PE profile to assess if U.S. stocks are cheap or expensive is outdated. For example, going back to 1995 or 30 years, the average forward PE profile of the R1000 Index was 17.6X and using that long-term average forward PE would indicate that U.S. stocks are 40% overvalued (see table, lower right). Given the increased concentration of the U.S. stock market driven by the explosive growth of the Magnificent 7 mega-cap tech stocks, combined with a higher profitability profile of U.S. stocks over time, it's more appropriate to evaluate U.S. stock market valuations over more recent timeframes.

The right side of the chart shows the 5/10/15 year average forward PEs for the Russell 1000 Index and compared to the current 24.6X forward PE profile. The table shows that the current PE premium for the R1000 Index is elevated even if using a shorter time period for making a valuation assessment. Using the shortest 5-year timeframe, the Russell 1000 Index is 17% overvalued compared to its 5-year average forward PE profile. The latest Russell 1000 Index valuation data suggests there is a substantial AI related valuation premium embedded in large cap U.S. stocks today.



Source: FactSet. Data from 9/30/1995-9/30/2025.

Another way to assess global equity valuations is to evaluate them regionally and compare how each region is currently valued against its own history and versus other regions. The following table uses a 10-year forward PE valuation data from the MSCI regional stock indices. On the left are U.S. stocks and the data shows the MSCI U.S. Index trades at a 23.6X forward PE, which falls into the 96th percentile of its 10-year forward PE valuation range. Furthermore, going down to the sector level, the data shows the U.S. Information Technology sector (INFT) trades in the 99th percentile of its 10-year valuation history. By comparison, U.S. small caps trade in the 37th percentile and U.S. midcaps trade in the 52nd percentile of their 10-year forward PE valuation histories. Looking at the other major regions, Europe trades in the 71st percentile and Asia Pacific in the 89th percentile of their 10-year forward PE valuation histories. So, neither region is super cheap but compared to their own history they are not trading as expensive as U.S. large caps and the tech sector, which stand out like a sore thumb as the most richly valued segment of global stocks. European small and mid-caps currently are the cheapest segment of global stocks but the same is not true for Asia Pacific small and mid-cap stocks. While investor sentiment towards U.S. small caps is low, it is even worse for European small and mid-cap stocks. As it relates to sectors, while the U.S. technology and financial sectors trade at their most expensive levels of the past 10 years, European consumer (CONS) and healthcare (HLTH) stocks have never traded more cheaply over the past decade, with both sectors currently trading in the 3rd percentile of their 10-year forward PE valuation history.

Figure 20. Relative to their 10-year history of valuations, US equities are at the 96th %-ile, while APAC equities are at the 89th %-ile, and European equities are at a distant 71st %-ile

NTM P/E	USA			Europe			Asia Pacific		
	Current	10y Pctle	vs. SPX	Current	10y Pctle	vs. MXEU	Current	10y Pctle	vs. MXAP
Overall	23.6x	0.96		14.8x	0.71		15.7x	0.89	
Small	17.1x	0.37	0.04	13.7x	0.33	0.14	16.4x	0.91	0.46
Mid	17.5x	0.52	0.08	14.0x	0.28	0.00	16.6x	0.90	0.29
Large	23.6x	0.96		15.0x	0.79		15.5x	0.89	
COMM	21.3x	0.87	0.66	18.0x	0.89	0.85	21.3x	0.90	0.73
COND	30.7x	0.82	0.63	16.3x	0.83	0.87	17.1x	0.82	0.61
CONS	21.5x	0.88	0.08	15.3x	0.03	0.00	20.8x	0.23	0.00
FINL	16.9x	0.95	0.41	10.8x	0.70	0.69	11.1x	0.97	0.45
HLTH	17.1x	0.63	0.05	14.7x	0.03	0.03	22.6x	0.06	0.00
INDU	25.4x	0.90	0.83	21.2x	0.86	1.00	16.7x	0.89	0.75
INFT	31.3x	0.99	0.81	27.5x	0.77	0.81	18.2x	0.84	0.65
MATR	20.8x	0.82	0.16	16.8x	0.86	0.88	15.7x	0.90	0.78
UTIL	18.9x	0.67	0.13	12.7x	0.16	0.02	11.9x	0.32	0.10

10y Pctle = 10y daily percentile relative to its own history. Whereas, 10y Pctle calculations vs SPX, vs MXEU, and vs MXAP are calculated against these benchmarks. Europe = MSCI Europe (MXEU), Asia Pacific = MSCI Asia Pacific (MXAP). Data as of 9/22/2025

Source: LSEG Data & Analytics, Bloomberg, Barclays Research

Any investor that properly respects risk should be taking these relative valuation setups into consideration in terms of managing risk and allocating assets across a portfolio.

Summary

For those investors that have been fortunate to be on the right side of having the most exposure to U.S. mega cap tech stocks over the past five years, it has been a richly rewarding experience. Thank your lucky stars and consider picking up the bar or meal tab on some night out with your friends. Outsized returns are always great but at this juncture in the stock market cycle, it would wise for investors to pay heed to the enduring relevance of Benjamin Graham's and Peter Bernstein's perspectives on risk. R-E-S-P-E-C-T for risk should become a higher priority after an extended period of outsized returns from a narrow group of stocks that now dominate the weight of global stock benchmarks. As it was for Aretha in 1967, just a little bit of R-E-S-P-E-C-T for risk would be a very positive and smart move for investors today.

Mark J. Majka, CFA
Chief Investment Officer
October 13, 2025

IMPORTANT DISCLAIMER: